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# FIRST NATIONAL CITY BANK

## Monthly Letter

### Business and Economic Conditions



#### General Business Conditions

New York, August 1961

**T**HE continuing vigor of the upswing has both surprised and heartened business leaders, who now look with confidence toward the autumn. The storm clouds over Berlin have created uneasiness, but President Kennedy's moves to meet the situation will further increase the demands on the economy and, for the short run at least, will add to the supporting influences.

Meanwhile, the recovery news has been better than expected. Gross national product rose dramatically to a new record rate of \$515 billion in the second quarter, a gain of almost 3 per cent from the low last winter. Industrial production has virtually regained its recession losses. Home and highway building continues to climb. Both employment and factory hours have increased. The gain in personal incomes since March has been among the best in peacetime since World War II. And, while the nation relaxes during the summer vacation season, production and trade are holding up well.

Official figures now available not only confirm that the recession was the mildest since the war, but that the recovery has been the fastest. Within one year of the start of the recession, GNP—the most comprehensive measure of economic activity—has risen to a point \$9 billion higher than the previous peak. The industrial production index, only four months after the upturn got under way, has regained eight of the nine points lost in the recession; even in the V-shaped recession of 1958, the lost ground was not made up until ten months after the turn.

#### Sustaining the Expansion

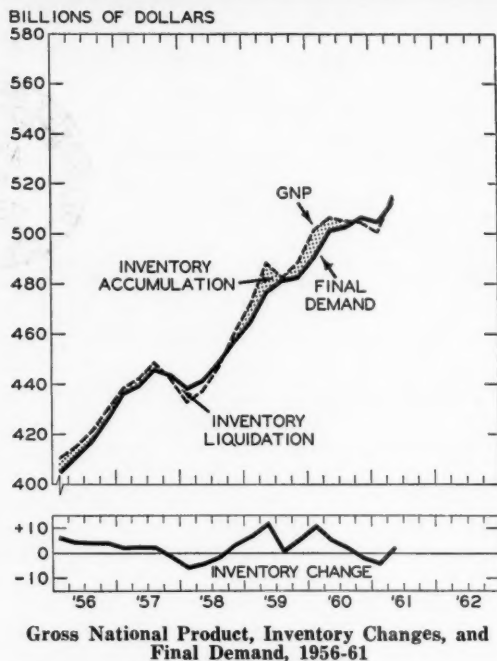
While all this has been encouraging, businessmen recognize that many problems remain to be solved if the upturn is to be turned into an extended period of healthy expansion. The recovery to date has been powered largely by completion of inventory liquidation, which has brought needs to produce as much as we have been consuming, and by increased government payments. From here on, the upswing normally will hold its momentum under influences of increased consumer spending, stimulation of business capital expenditures and, perhaps, some tendency toward inventory building consistent with enlarged business volumes. Consumers have shown some signs of breaking out of their recession-bred caution as incomes rise and job security increases. A moderate but steady pickup in retail sales has been under way since May.

A real recovery in capital expenditures, however, hinges on a healthy recovery of profits. As explained in the following article, markets are acutely competitive and profit margins, though improving, are still less than satisfactory. Looking for some respite from rising costs, businessmen are keeping a watchful eye on the auto wage negotiations. At the same time, hopes have begun to fade for a start on the kind of broad tax reforms needed to create a better environment

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Source: U.S. Department of Commerce.

for economic growth. The President, in his speech a week ago, pointed out that the improved business outlook means improved revenues. Nevertheless, he said, should an increase in taxes be needed to cover enlarged defense spending and get a balanced budget for fiscal '63, "those increased taxes will be requested in January." On the other hand, the proposed tax credit for capital spending, modified to meet businessmen's objections, has been tentatively approved by the House Ways and Means Committee. It would give a flat 8 per cent credit for investment in new equipment (excluding buildings and most public utilities) up to 50 per cent of tax liability.

#### **Broad Advance in Industrial Output**

Following the fast rebound in April and May, industrial activity rose more moderately in June. But even so, the Federal Reserve production index (seasonally adjusted, 1957=100) gained 1.7 points to reach 110, only 1 point below the record high reached in January 1960 and slightly better than the May 1960 level immediately before the downturn started. Pacing the advance in June were the consumer goods industries, where over-all output pushed above the previous high set a year earlier. Practically all the major manufacturing lines shared in the advance; note-

worthy gains were scored in textiles, TV and radio, chemicals, and construction materials. Machinery output continued to forge ahead, with the emphasis on office equipment. Passenger car assemblies moved up smartly, with the benefit of aggressive selling efforts, which brought May-June sales within 7 per cent of 1960 results. Earlier in the year, sales had lagged 20 per cent behind year-ago figures.

The inflow of new orders to durable goods manufacturers leveled out in June, following the strong rise which began in February and signaled the business upturn. Too much weight should not be given to July figures, affected as they are by vacation shutdowns of plants. But symptoms of fall improvement are reported by steel makers who report a good base of orders for August delivery from a wide range of industries, the only notable exception being the auto companies which are having difficulty foreseeing their needs because of a possible strike. Rebounding from the usual holiday drop, steel output in late July was back at an annual rate of 97 million tons, with rates ranging beyond 110 million generally anticipated for the autumn.

Detroit, now in the midst of model changeovers, is clearing the decks for a start on 1962 model production early this month. Barring a strike, auto assemblies, from a scheduled 180,000 in August, are expected to approach a half million in September. Dealer stocks, totaling no more than 920,000 on July 20, and 144,000 less than a year earlier, are being drawn down to the low normally associated with the model changeover. Car sales in the first 20 days of July declined less than usual from the June level and moved ahead of the comparable 1960 period.

Additional stimulus is now coming from a fresh upswing of homebuilding activity, helped by generous availability of mortgage credit. Private housing starts picked up again in June to a seasonally adjusted rate of 1,374,000 units a year, 38 per cent above the December low and the highest in 16 months. Other gains, especially in highway work, are expected to push construction spending to a new record for the year of nearly \$58 billion, according to a Commerce Department estimate. To achieve this would require a second half pace of \$60 billion a year, compared with the June rate of \$56.5 billion.

#### **A Brighter Employment Picture**

Pessimism over unemployment, so freely expressed last winter, has weakened somewhat, though President Kennedy last month stressed his view that "unemployment is bad enough when there is a recession, but it is intolerable

when there is prosperity." The economy's ability to create jobs received a further test in June as a record group of 2.5 million teen-agers entered the labor market with the vacation closing of schools. Employment responded with a rise to a new peak of 71.2 million. The record of employment so far this year has been impressive even though the official count of jobless persons has hovered around the 5 million mark and the unemployment rate between 6% and 7 per cent of the civilian labor force. The failure of the unemployment percentage to come down in response to the undoubted upsurge of business activity has puzzled many people and raised some fresh doubts as to the reliability of the data. The official figures do show that the labor force—people at work or reportedly wanting work—has been rising more rapidly than could be expected from population data. Many of the new entrants are wives and teen-agers.

Limiting employment opportunities, at least in the short run, is a tightening up of efficiencies in business enforced by difficulties of maintaining profit margins in the face of rising employment costs. Labor input, measured in manhours, has risen more rapidly than numbers of employees. As usual, during the early months of recovery, short-time work schedules have gradually been eliminated. Since December, when heavy snowstorms forced unplanned cuts in schedules, 1.7 hours have been added to the work week. By June, factory hours on the average were back to the normal 40-hour week. Factory employment has turned up sharply since April, especially in steel, autos, and other durable goods lines.

### **Recovery in Corporate Profits**

The upswing in business has brought a marked revival in corporate profits from the depressed levels of early 1961. According to reports issued to date and tabulated by this bank, net earnings after taxes of 692 leading nonfinancial corporations for the second quarter were up 19 per cent over the initial three months of the year. Earnings nevertheless fell 2 per cent short of the second quarter of 1960. With the weak first quarter, the first half performance was 12 per cent below 1960.

In manufacturing, where the recession hit hardest, reports of 519 firms show profits up 23 per cent from the first quarter but down 2 per cent from second quarter 1960. First half profits fell 14 per cent below last year.

Improvement in manufacturers' profits was the result of enlarged sales rather than any

fundamental change in the relationship between costs and prices. During the second quarter, demand for goods revived along a broad front and business shifted from liquidating inventories to rebuilding them. Sales of manufacturing firms reporting to date rose 11 per cent over the first quarter. Because profits naturally are more volatile than sales, the calculated profit margin for manufacturers reporting both sales and earnings picked up from 5.4 cents per sales dollar in the first quarter to 6.2 cents in the second. This brought margins back nearly to the 6.3 rate that prevailed in the second quarter of 1960, before the recession.

Early in a recovery—to an extent not possible when operations are closer to capacity—a step-up in operations permits fuller and more efficient use of facilities and manpower, and at the same time fixed costs are spread over a greater volume of output. Also, as volume increases, management can realize more fully the benefits of economies and improvements in techniques undertaken during the contraction.

The reductions in unit costs thus achieved help to relieve the profits squeeze between costs and prices. In the latest quarter, upward pressure on employment costs persisted, while selling prices were subjected to greater downward pressure than had been evident for many years. Sharp competition for business brought forth a wide variety of announced reductions in posted prices, as well as an untold number of unpublicized price cuts.

### **Gains in Manufacturing**

Three out of four of the manufacturing firms reported gains in earnings between the first and second quarters. The over-all increase of 23 per cent in manufacturers' profits was one of the sharpest in the past decade. But an increase of this magnitude was needed to bring profits back approximately to the level of the second quarter of 1960, so great had been the shrinkage of income during the intervening quarters.

The best gains from the first quarter to the second were scored in the steel, building materials, and automobile industries, where declines of 30 to 40 per cent had occurred from the last quarter of 1960 to the first quarter of 1961. Almost all the steel companies for which reports are available had substantially higher earnings in the second quarter, reflecting the steady recovery in sales and production during the first half of 1961. Only one of the 31 steel companies had a deficit in the second quarter, against eight in the first quarter.

**NET INCOME OF LEADING CORPORATIONS FOR THE SECOND QUARTER AND FIRST HALF YEAR**  
(In Millions of Dollars\*)

No. of Cos.	Industry Groups	Reported Net Income			% Change from		Reported Net Income		Per Cent Change
		Second Qr. 1960	First Qr. 1961	Second Qr. 1961	Second Qr. 1960	First Qr. 1961	1960	First Half Year 1961	
33	Food prod. & beverages	\$ 80.8	\$ 79.1	\$ 89.7	+11	+13	\$ 161.1	\$ 168.8	+ 5
7	Tobacco products	62.5	59.0	68.6	+10	+16	117.0	127.6	+ 9
22	Textiles & apparel	18.4	13.3	15.2	-17	+15	36.5	28.5	-22
8	Tires, rubber products	24.5	17.4	26.3	+ 8	+51	51.7	43.8	-15
29	Paper & allied products	56.9	42.9	48.7	-14	+13	107.5	91.6	-15
25	Chemical products	211.7	159.9	198.7	- 6	+24	411.4	358.6	-13
29	Drugs, soap, cosmetics	75.0	81.5	81.9	+ 9	+..†	161.4	163.4	+ 1
27	Petroleum prod. & refining	441.4	557.2	510.4	+16	- 8	986.8	1,067.6	+14
35	Cement, glass, and stone	102.0	42.3	87.6	-14	+107	171.9	129.9	-24
31	Iron and steel	203.7	79.6	188.2	- 8	+136	540.2	267.8	-50
29	Electrical equip., radio & TV	104.6	78.2	85.3	-18	+ 9	209.9	163.5	-22
49	Machinery	102.5	96.7	111.2	+ 9	+15	191.2	208.0	+ 9
14	Nonferrous metals	55.2	38.4	52.3	- 5	+36	105.2	90.7	-14
81	Other metal products	83.9	62.4	91.1	+ 9	+46	161.3	153.5	- 5
24	Automobiles & parts	340.0	173.9	282.4	-17	+62	717.6	456.4	-36
18	Other transp. equip.	27.1	25.7	24.0	-12	- 7	47.3	49.7	+ 5
58	Misc. manufacturing	87.7	52.9	80.6	- 8	+52	155.8	133.5	-14
519	Total manufacturing	\$2,077.6	\$1,660.6	\$2,042.3	- 2	+23	\$4,283.7	\$3,702.9	-14
16	Mining & quarrying	33.6	23.8	31.0	- 8	+30	58.7	54.8	- 7
33	Trade (retail and wholesale)	44.1	43.2	43.5	- 1	+ 1	89.1	86.8	- 3
24	Service & amusement	19.9	18.8	19.4	- 3	+ 3	36.0	38.2	+ 6
46	Railroads	126.7	.4	72.6	-43	+..†	226.0	73.0	-68
47	Electric power, gas, etc.	161.1	219.8	171.4	+ 6	-22	371.7	391.3	+ 5
7	Telephone & telegraph	327.5	327.7	341.6	+ 4	+ 4	635.4	669.3	+ 5
692	Total	\$2,790.6	\$2,294.4	\$2,721.8	- 2	+19	\$5,700.6	\$5,016.2	-12

\* Per cent changes and totals computed from unrounded data.

† Increases or decreases of under 0.5% or over 200% not shown.

The upswing in construction activity bolstered both sales and earnings of building materials producers. On the other hand, the lag in business spending on plant and equipment resulted in fairly stable profit margins and less than average increases over the March quarter in earnings of machinery and other capital goods manufacturers. Sales and earnings in these lines in the second half will in turn depend largely upon the ability of businessmen to achieve and maintain a satisfactory level of profits.

In nondurable goods industries, chemical companies reported about average gains in sales and earnings, despite considerable pressure on prices. Textiles and paper also reflected price shading in less than average profit increases. Sales and earnings of drug manufacturers were about the same as in the first quarter.

The experience of petroleum companies was in contrast to that of most other industries. In the first quarter, unusually cold weather had brought heavy demand at better prices, resulting in good earnings reports, but in the second quarter sales slipped, prices weakened, and earnings dropped 8 per cent. Continuing gains overseas helped the international oil firms. Compared with a year earlier, net income for the oil group was up 14 per cent.

Gas and electric utilities experienced a seasonal decline in earnings though profits were up 6 per cent over the corresponding 1960 period. Railroads were in the black, but barely, in the June quarter. Earnings for the first half were

negligible, down 68 per cent from the already shrunken figure for 1960.

### The Public Debt Limit

On June 30, President Kennedy signed a bill raising the "temporary" limit on the public debt from \$293 billion, effective for the fiscal year ended June 30, to \$298 billion for the new fiscal year beginning July 1. Action was urgently needed to prevent the debt limit from dropping back to the "permanent" statutory ceiling of \$285 billion and thereby raising a question of the legal status of the \$289 billion public debt then outstanding. Putting the limit up to \$298 billion provides ample leeway for Treasury deficit financing in the months just ahead, when seasonal weakness in revenues and growth in federal spending will push the debt up to a new peak.

The \$5 billion-plus deficit shaping up for fiscal '62 makes another increase in the debt limit, a year hence, a foregone conclusion. *The New York Times* commented editorially:

Had the ceiling not been raised . . . the debt would have been higher than its legal limit and the whole world might come to know how meaningless the limit really is.

The debt limit does not limit the debt. In the long run, the debt rises or falls as the result of deficits or surpluses in the Federal budget, not as the result of any statute that says it shall not pass a certain point.

While the Administration asked only for a temporary increase in the limit, the report of the Commission on Money and Credit calls for abol-



ishing the ceiling as a means of "broadening the range of discretionary debt management authority exercised by the executive branch of the federal government." The Commission charged: "Not only has the debt ceiling failed to promote fiscal responsibility and to control expenditures, but also it has restricted the Treasury's freedom in managing the debt." Eighteen months ago, the majority report of the Congressional Joint Economic Committee, headed by Senator Douglas, described the debt ceiling as "an arbitrary check on the government's budget decisions" which has contributed to "rash fiscal actions." The report went on to say: "If the fiscal, monetary, and debt management reforms which we have advocated were put into effect, the debt ceiling could be removed."

Skeptics as to the value of the ceiling find support in the fact that this is the seventh time since 1954 that Congress has agreed to a "temporary" debt limit in excess of the "permanent" ceiling. The latter itself has been raised from the \$275 billion set in 1946 to \$283 billion in 1958 and \$285 billion in 1959, as the accompanying chart shows. The new "temporary" ceiling of \$298 billion is the highest in our history except for a brief period at the end of World War II.

Limitations on powers of governments to incur debt are common. Reflecting past embarrassments over excessive borrowing, the constitutions of all but a few of our state governments prohibit or limit borrowing except by constitutional amendment or popular referendum. The Federal Government, of course, has the power to create money and thus—if willing to take this perilous path—need never default on an obligation. But this consideration makes limitations on Federal Government borrowing all the more important if the dollar is to preserve its value and if furtive

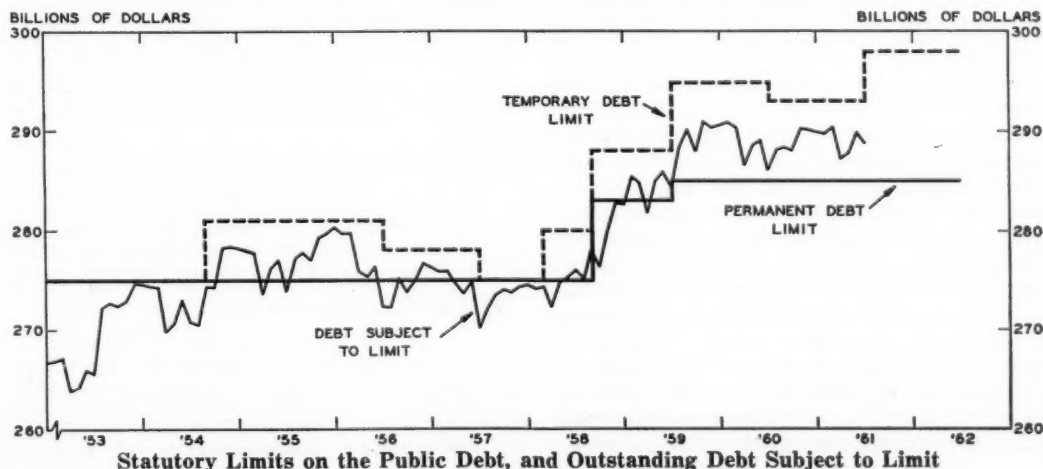
default through inflation is to be avoided. Under our Federal Constitution, the Congress has both the power "to coin money, regulate the value thereof" and "to borrow money on the credit of the United States." The former power has been delegated to the Federal Reserve, responsible to the Congress. The power to borrow has been delegated to the Executive subject to two main restrictions: the limit on the debt, and the interest rate limit of 4½ per cent payable on Treasury bonds. The Commission on Money and Credit would eliminate both limits. Of the two, the rate limit is more clearly harmful, forcing the Treasury to favor inflationary short-term financing.

The debt limit is part of our political system of checks and balances. While the Executive is responsible for programming federal expenditures, and can therefore vary the pace of spending, he must stay within the framework set by Congressional appropriations and authorizations—and within the statutory limit on borrowing.

Defenders of the debt ceiling, such as Senator Harry F. Byrd, point out that the absence of a limit, or a limit set far above current debt, would be "an invitation to extravagance." The Congress, often bold in authorizing spending, tends toward "stinginess" in setting the debt limit. And that is why it is a matter of some importance. When he was Secretary of the Treasury, George M. Humphrey expressed strong support for the debt limit concept:

... I think that the restraint the present debt ceiling gives to the Executive, to the Congress, to everyone concerned is a very wholesome thing to have, and I think that it is like breaking through a sound barrier; there is an explosion when you go through it, and there ought to be one.

It has weight with public sentiment, and I think it is a deterrent to spending over and above that amount. So, I am in favor of it.



Statutory Limits on the Public Debt, and Outstanding Debt Subject to Limit

### *The Record of Experience*

As the accompanying chart shows, a temporary ceiling of \$281 billion was granted in 1954 to make room for deficit financing which lifted the public debt above \$280 billion. The ceiling was cut back in 1956 and 1957, when budget surpluses allowed debt reduction. Beginning in early 1958, there has been a series of debt limit increases, allowing the debt to climb above \$290 billion. Clearly, the debt ceiling has not served as an inflexible barrier to spending and borrowing.

On the other hand, changes in the debt limit have not been a meaningless formality—as evidenced in pressures for abolition. When the debt limit comes up for debate, Congressmen and Senators, editorial writers and citizens in general, have occasion to pause and ponder the evils of unbridled federal spending. And those evils are great: erosion of the value of money and of all promises to pay in the future, and taxation to the point of stifling productive effort.

The record of Congressional debate is studded with examples of the way the necessity to raise the debt limit has brought realization of how much spending has risen. One proposal to raise the ceiling some years ago provoked Congressman E. L. Forrester of Georgia to say:

This is a dark day for our country. We have now come to the point that everyone should have known would come. Profligate spending prompted by an utter disregard for the future has placed us where we are . . . I wonder if the President's request for raising the debt ceiling has sobered us any? Certainly this country has been on a protracted drunk, but if this does not sober us, nothing will.

Senator Clinton P. Anderson of New Mexico declared:

It has been perfectly obvious to a great many that, if we were not going to hold down appropriations, we would have to increase the debt limit. In my opinion, had a clear statement come to the Congress that it had better trim appropriation bills or be prepared to face an increase in the debt limit, there might have been somewhat different action on the part of Senators generally.

Congress has often granted less than the Administration requested — and presumably would have borrowed and perhaps spent in the absence of a limit. To be sure, the Treasury has sometimes managed to get around the statutory limit. In 1953, when the debt pressed hard against the \$275 billion limit, the Commodity Credit Corporation met its commitments by borrowing directly from the public—outside the statutory limit—rather than getting its funds from the Treasury. The Treasury further used \$500 million of “free gold” carried in its cash balances. Again in 1957 and early in 1958, the ceiling was

bypassed with the help of the Federal National Mortgage Association, which borrowed from the public and repaid previous advances from the Treasury. Such devices have been criticized as “devious practice” or “fiscal subterfuge,” but the possibilities they offer for escape are limited.

### *Budgetary Control*

One of the problems that has plagued the Congress has been the difficulty of arriving at responsible decisions on separate taxation and spending proposals within the context of an over-all budget position. The piecemeal approach to the task of appropriating money and deciding upon spending requests does not lend itself to a unified view by the Congress of the total budget effects. Moreover, actual expenditures are typically based on appropriations made several months or even years earlier. The availability of tens of billions of unexpended balances to government departments and agencies defeats Congressional control over the pace of actual expenditures. To make matters worse, a substantial amount of “backdoor spending,” based on authorizations to pay for programs by borrowing from the Treasury or directly from the public, escapes the appropriations process altogether.

The problem is to prevent control over the budget from slipping away from the legislative branch. One suggested remedy for these perennial difficulties has been an omnibus appropriations bill which would allow the Congress to review its appropriations for all programs in a single package. Another proposal, twice passed by the Senate but never approved by the House, would establish a Joint Congressional Committee on the Budget with its own expert staff to coordinate and analyze for the appropriations committees spending requests, revenue trends, and the resulting over-all fiscal position.

In the absence of such controls, periodic review of the public debt ceiling gives the Congress a workable tool for budgetary control. As Congressman Thomas B. Curtis of Missouri has put it:

. . . not being able to find any other practical device to control the budget [Congress] could, I am satisfied, use the review of the debt limit as a practical device where the Congress could exercise judgment in reviewing the entire budgetary picture.

Arguing along the same lines, Congressman Howard W. Robison of New York declared:

. . . while this debt management legislation . . . does not really limit the debt of the United States, being required to periodically consider temporary increases in the fictional ceiling does, as it is doing today, cause the Congress to re-evaluate its own financial record and responsibilities.

The public debt ceiling is much more than an anachronism carried along without purpose from years past. In his study, *The National Debt Ceiling*, published two years ago, Marshall A. Robinson of the Brookings Institution characterized the debt limit as "no mere appendage to fiscal administration; it has become a major instrument of public policy." In these days of persistent tendency toward federal deficits and rising public debt, the role of a debt ceiling is of greater importance than ever before.

### Whither Gold?

Even though the heavy gold outflows came to an end last February, and the U.S. Treasury's gold stock has since been recovering modestly, gold continues to figure prominently in public discussions. Yet, looking through the record, one is struck by a disconcerting lack of depth in much of our thinking about gold.

The suggestion is offered—most recently by the Commission on Money and Credit—that we repeal the 25 per cent gold reserve requirement against Federal Reserve note and deposit liabilities. The idea is to free ourselves of the rigidity of a fixed reserve, and to show the world that our entire \$17.5 billion gold stock is available, if necessary, to defend the price of \$35 an ounce. This proposal has a good measure of support; it would no doubt be many years before Fort Knox could be totally emptied. But what then?

The proposal raises more questions than it answers. We should know where we are heading and where we want to come out. Would we expect foreign government officials, bankers, and businessmen to believe that all our gold would be allowed to go out to maintain the \$35 price? Or do we wish to put ourselves in the posture of wanting to get rid of gold, thus making the dollar a straight-out credit or fiat money? Could the dollar as a currency and the United States as a nation maintain their world prestige if other countries were the sole possessors of the precious metal? Or would it be contemplated that other nations, too, would give up their official gold reserves and make gold a simple commodity, traded in free markets?

It is only by facing up to issues like these that we can arrive at intelligent policies. We have the problem of defining the proper place for gold in our monetary set-up as well as in the world currency system.

### Monetary Status Today

The United States abandoned the gold standard in 1933 and, since the enactment of the Gold Reserve Act in January 1934, has been on what

has been called an international gold bullion standard. The differences between the full gold standard and our present gold arrangements stand out clearly in the table.

### Full Gold Standard and Present U.S. Gold Arrangements Compared

Full Gold Standard	Present U.S. System
Monetary unit defined by law in terms of specific weights of gold.	The dollar defined as a specific weight of gold by Presidential proclamation under the Gold Reserve Act of 1934.
Currency freely redeemable in gold coins or bullion.	No gold coins coined; no U.S. currency redeemable in gold; private holding of gold unlawful. <sup>2</sup>
Free buying and selling of gold at a fixed price.	Purchases and sales at a fixed price, with sales limited to foreign monetary authorities for "legitimate monetary purposes" and to licensed domestic dealers for approved purposes.
Free gold export and import.	Free import of gold; export of gold subject to license.
Gold—legal tender for payment of debt.	All coins and currencies of the United States declared legal tender.
Gold cover for domestic currency.	Legal gold reserve requirement of 25% of Federal Reserve note and deposit liabilities.

<sup>2</sup> Except for gold in its natural state and gold coins of recognized value to collectors.

The present monetary status of gold is thus a hybrid one. The dollar is defined in law as a quantity of gold, but no dollars of the present weight of gold have ever been coined and U.S. currency is irredeemable in gold. Yet, at the same time, the U.S. dollar is linked to gold in the sense that the Treasury buys and sells gold at the statutory price of \$35 an ounce in transactions with foreign central banks and governments "for legitimate monetary purposes." These words have never been defined officially; but they were interpreted quite broadly in late 1960, following the flare-up in the London gold price, when the United States supplied gold through the Bank of England to private holders at a price in excess of \$35 in order to counter speculation that the dollar might be devalued.

The U.S. Treasury has no commitment to buy or sell gold; the present practice could, therefore, be changed without notice. But if the U.S. Treasury were to stop selling gold to foreign central banks at the official price, or buying gold from them, gold would be free to fluctuate in terms of the dollar, and foreign exchange markets of the Free World would be thrown into confusion until U.S. intentions were clarified.

No other country patterns its gold policy on that of the United States. We alone give fixed-price gold convertibility—though only to foreign monetary authorities. On the other hand, we suppress private holding and trading, while nations

abroad permit or even encourage free markets. Of these, the London market, reopened in 1954 after sixteen years, is the most important.

The United Kingdom forbids its citizens to hold or trade in gold; only nonresidents of sterling-area countries are allowed to buy gold in the London market—in effect against U.S. dollars. More commonly, however, free gold markets are conducted in local currencies; as in England, the monetary authorities participate. Only a few countries—including Germany and Switzerland—allow their nationals to export gold freely. A number of countries mint gold for sale in free markets. But no country has fixed prices for gold coins. None is on a gold coin standard. The last nation that could be so classified was Saudi Arabia, and the coin of the realm was the sovereign.

Less than half of the central banks in the world have—like the Federal Reserve System—legal gold (or gold and foreign exchange) requirements against their note issues and deposit liabilities. In many countries, including the United Kingdom, these requirements have been repealed or suspended, usually at times of national emergency; a number of central banks established since World War II, including the German Bundesbank, have no such requirements.

### ***Cutting Loose From Gold***

It is against this background that the recommendation of the Commission on Money and Credit to repeal the gold reserve requirement "as an archaic instrument of monetary control" should be considered. The law requires the Federal Reserve Banks to keep gold certificates equal to at least 25 per cent of their note and deposit liabilities. (The gold certificates are issued by the Treasury which has actual physical custody of the metal.) On this formula, the required gold cover works out to something over \$11 billion, as against the U.S. stock of \$17.5 billion. This leaves some \$6.5 billion in excess gold reserves—approximately \$3.5 billion less than our short-term liabilities to official foreign institutions, which are eligible for conversion into gold. Our short-term liabilities to private foreign holders stand at \$7 billion; these are not eligible for conversion unless sold to a central bank.

The idea is to make all of our gold available to cover short-term liabilities to foreigners, including those that may accrue in the future. Actually, the gold is already available since present legislation permits temporary suspension, with penalties, of the gold reserve requirement in case of need. But the Commission believes that:

... threat of a confidence crisis would be greatly reduced if it were generally recognized, both here and abroad, that all of the U.S. gold is available to meet our international obligations. Any doubts about the U.S. policy should be removed by elimination of the gold reserve requirement at the earliest convenient moment so that all of the U.S. gold stock is available for international settlements.

Arguments like these are persuasive. A "reserve, in the truest sense, should be available to meet emergencies. Another appealing point is that, since the dollar is no longer convertible into gold except for transactions with foreign governments and central banks, the need for a specific domestic currency cover is outdated.

Missing from the Commission's report, however, is any consideration of the need of the United States, with its far-flung international commitments and its position at the center of the monetary universe, for a gold reserve. Is it realistic to expect that, even with all our productive power to give real value to money, the U.S. dollar could command full respect under all circumstances? Unless gold is demonetized by international agreement—something that does not appear to be in the cards—the United States needs a gold reserve commensurate with its economic and financial strength and responsibilities. It also needs gold for use in emergencies; as a matter of fact, Russia attaches vital importance to gold as a war chest.

Granted this, it follows that we must form some conception of the levels below which the U.S. gold stock should not be allowed to fall. The British seem to have in mind something of this sort: for example, a decline in British reserves below £1,000 million at the end of June tripped off an emergency program announced by the Chancellor of the Exchequer on July 25 to defend the pound.

We must incorporate into our thinking on this question a clearer recognition of the need and function of a gold reserve, and emphasize more strongly the necessity of accepting the disciplines required to maintain it. What the minimum reserve requirements might be, and whether determination of the minimum should be incorporated in law, are arguable questions, but it is indisputable that protection of the gold reserve should be an objective of public actions and policies.

As the centerpiece of the international monetary structure, the dollar needs an especially strong reserve. Perhaps 40 to 50 per cent of our overseas liabilities should be construed as something of a danger point. The \$11 billion required gold cover under present law works out to somewhat over 50 per cent of gross overseas liabilities. Thus, by accident if not design, it affords a rea-



sonable conception of a level at which we should be awakened to a sense of crisis and need to take stern measures to retain for the dollar its place as an anchor of monetary stability. This is not to suggest either that in a time of gold losses corrective actions and policies can safely be deferred until this level is reached—that lesson was learned in 1960—or that we should take the occasion of a decline in reserves to this point as a reason for suspending gold payments or devaluing the dollar.

It may also be asked whether there is a point at which retaining a minimum gold reserve could become more important than keeping the \$35 selling price. Assuredly, it would make no sense to let all the gold go out and then to raise the bid price to recoup some of the loss. The way to avoid a devaluation of the dollar is, of course, to deal effectively with the hard core of our balance-of-payments difficulties, along lines often discussed in these pages. The real question is whether policies necessary to maintain financial stability would be implemented as promptly, as courageously, and as effectively if we were to eliminate the gold requirement as if we kept it. The requirement, as W. Randolph Burgess once said, is like a "red light"—a warning to hold inflation in check and keep spending abroad to what we can afford.

### European Views

There is also the problem of reconciling our views on gold with those of other financially developed nations, many of which have a strong attachment to gold. This is evidenced, first of all, in the form in which central banks choose to hold their international reserves—whether gold or dollars (or sterling). In Western Europe, the bulk of reserves is held in gold; this is true even of countries whose statutory gold reserve requirements have been suspended. The preference for gold, therefore, is only in part a matter

of legislation; it also reflects considerations of prestige and tradition, and the desire to protect reserves against the hazards of depreciation.

From early 1958 to early 1961, the greater part of Europe's gold gains came from the U.S. Treasury's \$5.4 billion loss. Beginning in March 1961, however, with heavy pressures on the pound sterling, the Continental gains have been largely at the expense of the United Kingdom, whose monetary reserves fell by \$423 million during the four months ended last June. Continental central banks have also added to their holdings of sterling—automatically secured by an exchange guarantee through the mechanism of the European Monetary Agreement—but increases in their foreign exchange holdings have been much smaller than in their gold stocks. During March-June, the central banks of France, Germany, and Switzerland added \$969 million to their gold stocks through purchases in London and from other sources.

The people of Western Europe retain their traditional respect for gold. They keep a weather eye on the state of their nation's official gold reserves as a vital indicator of the health of domestic finances. In addition, those who have had intimate experience with currency disorders find it desirable to build up private gold holdings. Actually, in a nation that follows sound financial policies, hoarding is practiced only by the most cautious people, willing to forsake interest income for what they hope will prove full protection against major upheavals, including unbridled paper money inflation of the type which occurred in a number of nations during and after the two world wars. To suggest, as does the Commission on Money and Credit, that "other countries might be persuaded to introduce legislation prohibiting private gold ownership at home and abroad, as the United States and the United Kingdom have done," is to disregard profound differences in monetary experiences, attitudes, and ideas among nations.

Another indication of European thinking about gold may be seen in the ideas advanced last month by M. Jacques Rueff, one of the architects of French financial restoration. M. Rueff voiced misgivings about the widespread practice of holding monetary reserves only partly in gold and the rest in dollars or sterling—the so-called gold exchange standard. He regards such "economizing" of gold as dangerous and, to avoid a repetition of the international currency collapse of the early 1930's, he recommends redemption in gold of the greater part of dollar balances held by central banks outside the United States.

M. Rueff proposes reduction in the 25 per cent U.S. gold reserve requirement to make such

Official Gold Stocks and Their Percentages in Total Gold and Foreign Exchange Reserves

	1957 (End of Period)		1959		June 1961	
	\$ mil.	% share	\$ mil.	% share	\$ mil.	% share
Switzerland	1,706	90	1,934	94	2,271	87
United Kingdom	1,600	70	2,500	91	2,625*	87*
Netherlands	744	87	1,132	85	1,464	86
France	581	90	1,290	75	2,020	73
Belgium	915	91	1,134	93	1,074	73
Italy	452	35	1,749	59	2,128†	72†
Portugal	461	62	548	68	496‡	69‡
Germany	2,542	63	2,637	58	3,514	51
Canada	1,100	60	960	51	906	45
Austria	103	21	292	43	293	44
Sweden	219	49	191	45	170	27
Japan	23	4	244	19	247§	14§

Countries arranged according to the percentage share of gold in total reserves in 1961.

\* March. † April. ‡ May. § December 1960.

Source: International Monetary Fund.

payments possible. He would call together an international conference to arrange for an orderly and gradual restoration of the gold standard. The time is overdue for an international conference—but to deal with the broader question of the place of the precious metals in our monetary systems. Little support is evident for restoring the old gold standard. On the other hand, the U.S. policy of suppressing private gold trading has not proved generally acceptable overseas. The most common practice abroad is to have free markets and treat gold as an asset to be held mainly in official reserves but also by private citizens as a store of assured value in an uncertain world. American citizens have shown no great interest in holding gold; yet the policy of forbidding Americans to buy gold in the free markets of the world is inconsistent with our traditions of freedom.

Whether we like it or not, the world in the decade of the Sixties does not dismiss gold as a "barbarous relic" or an "outworn dogma," as J. M. Keynes taught in the Twenties. Many people agree rather with one of Keynes' leading disciples, Professor Roy Harrod, that "the collective wisdom of mankind has assigned a certain role to gold . . . It may not be a perfect device, but on the whole it is a remarkably good one."

### ***The Role of Gold***

Gold has won its place in the world today as, over many centuries, man has groped toward workable ways to facilitate trade and store value through the use of money. Commodity money grew out of bartering; gold (and silver) coins became convenient media of exchange and stores of value; promises to pay gold became the most convenient means of payment; and nations, departing from the full-fledged gold standard, embarked upon monetary "management." But "management" did not always show itself as vigilant, skillful, and courageous as was necessary to ensure monetary stability at home and to enable the international monetary system to function properly.

There is no way to turn the clock back. By the same token, however, there is no practical possibility of cutting loose from gold altogether. There are times and circumstances when no other "money" is acceptable. Recognition of this helps reinforce monetary discipline—something we must have if we want an orderly society.

Gold guards against reckless budgetary and monetary practices by making it necessary for a country—whether or not it has a prescribed gold cover for its currency—to frame its domestic economic and financial plans and policies with continuing regard to the external influences

to which it is subject, as well as to the external repercussions of its own acts. Now that many currencies of Western Europe rank as good as the dollar, we are confronted with a healthy challenge to keep the dollar as the key reserve currency. The dollar and the gold reserve will take care of themselves if we restrain inflationary pressures, compete successfully in world markets, and measure government commitments abroad against what we can, by trade and judicious investment, earn overseas.

### ***The REA Through the Looking Glass***

In *Through the Looking Glass*, Alice discovered that words can be rather slippery things:

"When I use a word," Humpty Dumpty said in rather a scornful tone, "it means just what I choose it to mean—neither more nor less."

"The question is," said Alice, "whether you can make words mean different things."

Some readers recently were as startled as Alice on seeing how familiar words were used by the National Rural Electric Cooperative Association in a full-page advertisement given nationwide circulation. The ad pictures the skyrocketing growth of rural electric systems as an outstanding example of "free enterprise." It asserts that "4½ million people own rural electrics—more than any other business," more than A.T.&T.'s 1,900,000 shareholders, General Motors' 746,803, and Standard Oil of New Jersey's 526,610.

The thousand or so rural electric systems under discussion are "nonprofit groups—usually cooperatives." They have a lot of shareholders. Unlike corporations organized for profit, they typically require a membership fee—the purchase of one share—as a condition for providing service; thus, 4½ million is more genuinely descriptive of the aggregate number of customers than of the spread of ownership. The shares are of little investment value for they pay no dividends *per se*. The "profit" for the shareholder lies in access to power below its true cost. The cooperatives spare themselves from income taxes by avoiding realization of profits in the ordinary, legal sense. Further, the Rural Electrification Administration, supported out of the Federal Treasury, gives them a pipeline to the taxes paid by everybody else, including their competitors. The NRECA is too modest in totting up the number of owners of the "rural electrics"; a hundred million taxpayers have investments in them, involuntary and unprofitable but nevertheless real.

Last year the Congressional Joint Economic Committee published a report on "Subsidy and Subsidylike Programs of the U.S. Government." This document does not develop a picture of the electric cooperatives as "free enterprise." It

does not find the capital contributions of the beneficiaries important enough to mention. The REA, included in a chapter on "Agricultural Subsidy Programs," is described as extending loans to cover the full cost of constructing powerlines and other facilities:

The Rural Electrification Administration makes loans for the purpose of financing electric systems and telephone service to rural areas. By such loans it has made possible the extension of electric power and telephone service to many farms at an earlier date and at lower cost than would otherwise have been possible. In the field of rural electrification, which the REA has undertaken since 1935, the REA makes loans to qualified borrowers, with preference to non-profit and cooperative associations and to public bodies.

Loans cover the full cost of constructing powerlines and other facilities to serve persons in rural areas who are without central station electric service. They bear 2 per cent interest and are repaid over a maximum period of 35 years. . . .

The report gave an estimate of REA loans less repayments as of June 30, 1961: \$4.4 billion loans for electric service and beyond \$700 million for telephones. The total rises every year and will continue to do so as the cooperatives expand outside farm areas, take on commercial and industrial customers, build generating capacity, and extend telephone services. Against these aggregates of \$4 to \$5 billion, the "ownership" represented in membership fees of beneficiaries—at \$5 or so apiece—is a drop in the bucket. It takes care of less than one per cent of the total investment.

#### **Interest Rate Subsidy**

It is true that the cooperatives pay interest on borrowed money. But there is a continuing subsidy in the fact that the REA lends at 2 per cent while the Treasury has to pay an average of 3 per cent on the public debt. In the original Rural Electrification Act of 1936, the intent of Congress was that "all such loans . . . shall bear interest at a rate equal to the average rate of interest payable by the United States of America on its obligations, having a maturity of ten or more years. . . ." In 1944, when the Treasury was paying an average of 1.93 per cent on the public debt, the Congress fixed the REA lending rate at 2 per cent.

In his budget message of January 1959, President Eisenhower proposed that: "The present statutory interest rate of 2 per cent for loans made by the Rural Electrification Administration be replaced by a rate which will cover the current cost to the Treasury of equivalent-term borrowing and other reasonable costs." On this formula the REA would be charging upwards of 4 per cent. That is what the Treasury would have to pay today on long-term bond issues.

Mr. Eisenhower's plan drew a barrage of criticism and was never adopted. Yet the principle he set out seems reasonable:

Ideally, in a Federally sponsored and financed undertaking, it should be possible for the Government to step progressively aside as they reach the stage of self-sufficiency which enables them to move forward under their own sound management, ownership, and financing.

Consolidated income statements of investor-owned electric power companies and REA cooperatives make it possible to figure the subsidy elements. The cooperatives pay 3 per cent of their revenues in taxes instead of 24 per cent for the private utilities and 2 per cent on borrowed money instead of 4½ to 5 per cent. In 1959, when their operating revenues were \$618 million, the REA cooperatives would have needed \$164 million more revenues to raise their tax payments to the private utility average, and perhaps \$50 million besides if they had been required to meet the market on money costs. In other words, the cooperatives might have had to raise their rates around 35 per cent.

The flourishing development of the rural electric systems raises the question whether they are not now strong and enterprising enough to take their places as full-fledged, dues-paying members of the corporate society. Through subsidies and tax exemptions, we create powerful incentives for the establishment and growth of non-profit organizations. But the hard fact is that the vast Federal Government machinery demands a huge flow of taxable income and profits. It would grind to a halt, or fling itself apart in wild inflation, if we all went cooperative.

#### **"Living Backwards"**

The ad treats the 4½ million as participants in one single business and says that "a finer example of private enterprise . . . would be hard to find." The business in question must be the REA of which the "rural electrics" are common dependents or subsidiaries. It is, indeed, a topsy-turvy world when the REA system gets identified as private enterprise.

Pretty soon, as Humpty Dumpty might have been moved to mention, we may begin calling the private utilities public enterprises. After all, they are public utilities, serving everybody in the whole land. And they do turn the greater part of their profits over to the government.

Rich people, meanwhile, can come to be known as public servants. After all, they do spend most of their time working for the government.

Maybe we're suffering from the effects of "living backwards." As the White Queen once told Alice, "it always makes one a little giddy at first."

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